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The interplay of need and opportunity in venture capital investment syndication☆

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ABSTRACT

This study examines the syndication of investments novel to a VC firm as a function of the firm's need and opportunity to do so. We distinguish two types of uncertainty that firms face when considering novel investments: egocentric, pertaining to making the right decisions, and altercentric, pertaining to being evaluated as a potential partner on the investment. Whereas the former increases the firm's need to syndicate the investment, the latter reduces the firm's opportunity to do so, making it contingent upon the firm's status and reputation for attracting potential partners. Using data on first-round venture capital investments, we find that novel investments are more likely to be syndicated. Moreover, this relationship is stronger for firms with higher status and weaker for firms with higher reputation. These results highlight a relational aspect of uncertainty, inherent in a particular VC firm — investment dyad, and suggest that status and reputation play different roles in aligning the need and opportunity to syndicate novel investments.

1. Executive summary

For firms to form alliances, it is necessary for them to have both the need and opportunity to do so. This is equally valid in the context of venture capital syndications and we focus on how the need and opportunity for syndication align in the context of specific investments. While prior research has focused on the uncertainty characterizing a specific investment target (e.g. early stage or high technology) as a driver for syndication, we argue that such uncertainty need not be perceived uniformly among potential investors. Certain investments may be more or less uncertain *to different VC firms*, based on the extent of their prior experience in the specific industry of the investment. We thus focus on a hitherto unexplored, *relational* aspect of uncertainty, inherent in a particular VC firm — investment dyad and reflecting the VC firm's understanding of the particular company and its environment.

In view of this, the need and opportunity to syndicate a particular investment may not always be aligned: in certain situations – such as when the investment is novel to the VC firm – the factors that increase the firm's need to seek partners may also reduce the opportunity for the firm to find and attract needed partners. Such misalignment is related to the presence of two different types of uncertainty. On one hand, a VC firm faces (egocentric) uncertainty related to the proper decisions to be made in selecting and managing these investments. In such cases, the firm can benefit from the participation of syndicate partners and is thus likely to seek such partners. Yet, on the other hand, for these very same investments, it is difficult for potential syndicate partners to

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evaluate the focal VC firm as a worthy partner (altercentric uncertainty). In such cases, the opportunity for syndication is contingent upon the VC firm's ability to signal its quality to potential partners, such as through its status and reputation.

To test these theoretical insights, we studied 35,757 first-round investments made by 2498 US VC firms between 1980 and 2004. We considered an investment to be novel to the involved VC firm to the extent that it was in an industry in which the VC firm had limited or no prior experience. Consistent with our theoretical expectations, we found that novel investments were more likely to be syndicated. In addition, we found that the VC firm's status and reputation provided important nuances to this relationship. Status reinforced the relationship: VC firms with higher status are much more likely to form syndicates as the novelty of the investment increases. In contrast, and contrary to our expectations, VC firms with higher reputation exhibited a reduced likelihood for syndicating novel investments.

Our study suggests that need and opportunity, rather than being independent aspects of syndication and alliance formation, are in fact intertwined at the level of the projects for which firms may seek to form alliances. We provide an enriched understanding of the uncertainty residing in the relationship between a VC firm and the specific investments it undertakes. By their nature, novel investments involve domains in which the firm lacks sufficient knowledge and thus make the firm's need for alliance partners more salient. Yet, undertaking such investments can serve as a red flag for the firm's quality as a partner for these projects due to its uncertain ability to make project-specific contributions, which ultimately undermines its ability to attract partners for these investments. Potential partners, unable to assess the potential contribution of the focal firm, have to rely on their overall perceptions of the firm in deciding whether to join forces with it on such projects. While they both affect these overall perceptions, the firm's status and reputation exhibit different strengths and relevance as quality signals for novel projects. Reputation, anchored in the firm's prior activities and performance, may not be easily carried over to a new domain. In contrast, status – dissociated from specific behavior and grounded in existing relationships and affiliations – provides more resilience to firms in such uncertain situations.

Related to practice, our work suggests that in considering investments into unfamiliar or less familiar industries, VC managers need to be aware that, to the extent that they look for potential syndicate partners, such partners are less likely to be swayed by the firm's prior track record and more by its prior associations. More broadly, our results suggest to managers that tradition and past successes can be discounted when looking to attract partners for novel projects and that, to the extent there is continuous pressure to look for new opportunities, careful attention needs to be paid to the cultivation of relationships that can make such opportunities more accessible.

2. Introduction

Inter-firm alliances represent an important topic for organizational research and significant research effort has been extended to understand why they occur. Put concisely, firms form alliances when they *need* additional resources or when they have the *opportunity* to know and attract potential partners (Eisenhardt and Schoonhoven, 1996). The former stems from a vulnerable strategic position (Eisenhardt and Schoonhoven, 1996), lack of adequate knowledge (De Clercq and Dimov, 2008) or quest for legitimacy (Baum and Oliver, 1992; Stuart et al., 1999). The latter is afforded by possession of network resources (Gulati, 1999) or a strong position in the market space (Stuart, 1998).

While prior literature has largely focused on the firms' overall tendencies to form alliances as explained by market conditions (Kogut, 1988), industry competition (Gimeno, 2004), firm attributes (Chung et al., 2000), or some combination of these (e.g. Eisenhardt and Schoonhoven, 1996; Koza and Lewin, 1998; Park et al., 2002), there has been limited consideration of the nature of specific projects for which alliances are formed. This is unfortunate, because it is at the project level that needs are assessed, partners' contributions to the alliance are evaluated (Doz and Hamel, 1998), alliance governance structure is determined (Casciaro, 2003), and the project's outcomes for partners are appraised. Moreover, it is at this level that the need and opportunity for alliance formation are intertwined in ways that cannot be anticipated by existing theory. On one hand, firms with plentiful opportunities to form alliances may not necessarily need such alliances for particular projects. On the other hand, firms in need of partners for particular projects may find it hard to find or attract partners for those projects. Hence, project considerations are important to the extent that they affect the firm's decision to seek partners and the prospective partners' decision to enter an alliance.

Individual-project considerations are particularly potent in the context of the venture capital (VC) industry, where a substantial proportion of investments are made by syndicate partnerships involving two or more VC firms (Bygrave, 1987; Lerner, 1994; Manigart et al., 2006). In addition to its benefits for the management of the VC firm's total portfolio – such as diversification, sharing financial risk, and increasing deal flow (Lockett and Wright, 2001; Manigart et al., 2006; Norton and Tenenbaum, 1993; Sorenson and Stuart, 2001) – syndication can also be instrumental for the selection and management of individual investments by affording the VC firm access to wider knowledge and skill sets (Brander et al., 2002; De Clercq and Dimov, 2008; Lerner, 1994). Indeed, research has shown that when investing in companies that are highly innovative (Bygrave, 1987) or less established (Lockett et al., 2002), VC firms tend to seek syndicate partners in order to deal with the uncertainty encompassing such projects. Yet, implicit in this work is the notion that the uncertainty residing *in* the specific investment targets is uniformly perceived among potential investors, regardless of their own characteristics or experiences. Questioning this premise reveals a hitherto unexplored *relational* aspect of uncertainty, inherent in a particular VC firm — company dyad, which accounts for the different understanding that various VC firms may have of the specific company and its environment. This raises the question of the considerations and factors that propel and enable particular VC firms to syndicate particular investment projects.

Accordingly, this study seeks to understand the syndication of individual investments as a function of the VC firm's need and opportunity to do so. We relate these factors to the degree of novelty that the investment represents for the VC firm and distinguish